Supervising Multinational Banking Organizations:

EVOLVING TECHNIQUES FOR COOPERATION AMONG SUPERVISORY AUTHORITIES*

W. Peter Cooke

MR. MUNDHEIM: We have heard that some of the problems between the host and the home country could be smoothed out by international cooperation. Peter Cooke has been one of the leaders in the effort to develop international cooperation among supervisory agencies. Peter, would you talk a little bit about that approach to the problem?

MR. COOKE: Thank you, Bob. Those of you who just heard Neal Petersen and Alain Hirsch's remarks will realize how difficult it is to foster this international cooperation.

I would like to spend a few minutes talking about the international framework of supervisory cooperation within which the debate about Y-7, and its relation to the operation and supervision of foreign bank branches and affiliates in the U.S. and U.S. branches and affiliates abroad, is being conducted.

1. RECONCILING DIFFERENT LEGAL SYSTEMS

First of all, an obvious remark. You cannot regulate internationally unless you have a governing international law. You can only supervise. International supervisory techniques and agreements on common approaches only become legally based when they are incorporated within different national systems on a consistent basis. This problem of reconciling different legal systems, different regulatory approaches, will pervade my remarks.

A. Domestic Supervision

I want to begin by reminding you of the environment in which international supervision developed. Supervisors are domestic animals, or they certainly were until the 1970s. Then, all of a sudden, spurred on by events like the failures of Herstatt Bank and the Franklin National, supervisors came to a rather salutory perception of the degree to which banking had become internationalized and the degree, therefore, to which supervisory techniques and procedures should also be internationalized.

They realized that there was a supervisory vacuum in the global marketplace and that it needed to be filled. Filling this

* Mr. Cooke's remarks were based on a more detailed paper, Developments in Cooperation Among Bank Supervisory Authorities. That paper is reproduced in the Appendix to this chapter.
vacuum involved two steps: first, the adaptation of essentially domestic supervisory systems to the international marketplace, and second, the need for cooperation among the domestic authorities. There are two ways in which this cooperative effort can be pursued and they can be characterized very clearly, I think, in the work of two groups which are the most active in this field.

B. Steps Toward Global Supervision

The first, and the first in time, was a group which was set up among the supervisory bodies of the European Community. It was called the Groupe de Contact, and it set out to meet on an informal basis to discuss supervisory problems within the European Community. It later developed a parallel role, undertaking technical studies for formally constituted bodies within the European Community. The ultimate objectives of the Community are directed towards the harmonization of banking legislation in the affected countries. That particular route is one which seeks to produce, by way of European-based legislation, a convergence of national laws and practices to produce a common system within which banks can operate across national boundaries within the European Community.

The second approach—perforce a more informal approach—is that which is followed by the supervisors of the main industrialized countries meeting in Basle. It is essentially one of informal cooperation. It provides a forum for the formulation of guidelines for international supervision, for personal contacts between supervisors, and for mutual education about each other’s systems. Most important, it ensures that at least among the major countries, and I hope more widely as the message is spread, there will be no significant gaps in international supervisory arrangements. This group does not seek to promote harmonization of law or regulation, although it may be—and I would certainly hope that this would happen—that some element of convergence of practice in different countries will come about through a developing perception of each country’s best practice.

2. THE BASLE COMMITTEE OF SUPERVISORS

I want to focus my remarks this afternoon on the work of the Basle Committee of Supervisors. What is that committee trying to do? We are trying to exercise an appropriate measure of control over the international banking system. That system needs to be allowed to work so that it can fulfill its function of financing international trade. Although the system must be given scope to develop, it must develop in an orderly manner. A delicate balance must be struck between maintenance of national interests and the freedom of the international marketplace. The real problem with supervising the international business of banks is that if they are supervised too rigidly the banks can just walk away and do their business somewhere else where the supervision will be much less stringent. Hence, the growth of the offshore center, as it is sometimes known, which permits the banking system to escape the fiscal and monetary control regulations of national authorities. Indeed, the growth of the Euro-currency markets in the first instance derived from measures taken by the U.S. authorities for domestic reasons. So, there is a delicate balance here to be maintained.

There are two main strands of the work which is being pursued and the understandings which are being sought internationally. The
first is what has come to be known as the Concordat. This name is somewhat obscure. It relates, if my history does not desert me, to certain activities of the medieval papacy—which is perhaps not an unreasonable antecedent for modern day banking supervisors.

A. The Concordat

The principle of the Concordat was developed in the very early days of international supervisory cooperation, in the mid-1970s, because there were no established practices relating to the overlapping responsibilities of different national supervisors where banks were conducting business across national boundaries. It sets out guidelines covering the responsibilities of different supervisory authorities for the ongoing supervision of banks where those banks operate in more than one national jurisdiction. It is not, and it was never intended to be, an agreement for the provision of lender-of-last-resort facilities to the international banking system. There should not be any automatic link between acceptance of responsibility for ongoing supervision and the assumption of a lender-of-last-resort role.

The aim of the Concordat, then, is to sustain, as far as possible, the health and safety of the existing structure. It does not set out to rule on the way in which the pieces of that structure should be picked up if it is broken. The Concordat encompasses the following principal guidelines and recommendations:

1. The supervision of foreign banking establishments should be the joint responsibility of host and parent authorities.
2. No foreign banking establishment should escape supervision, each country should ensure that foreign banking establishments are supervised, and supervision should be adequate as judged by both host and parent authorities.
3. The supervision of liquidity should be the primary responsibility of host authorities since foreign establishments generally have to conform to local practices for their liquidity management and must comply with local regulations.
4. The supervision of solvency of foreign branches should be essentially a matter for the parent authority. In the case of subsidiaries, while primary responsibility lies with the host authority, parent authorities should take account of the exposure of their domestic banks' moral commitment in this regard.
5. Practical cooperation would be facilitated by transfers of information between host and parent authorities and by the granting of permission for inspections by or on behalf of parent authorities on the territory of the host authority. Every effort should be made to remove any legal restraints (particularly in the field of professional secrecy or national sovereignty) which might hinder these forms of cooperation.

I have gone into some detail on this agreement because it is the cornerstone of all international supervisory cooperation which has been developed since that time. Indeed, it has recently been reexamined and found to be still an adequate statement of the basic approach towards international supervisory cooperation.

Just in passing, I might say that the Concordat has an implication for the operation of the Y-7 Report and associated forms. I have a great deal of sympathy with what Alain Hirsch has said. At the same time, because I try to sit in a position which enables me to see the best sides of everybody’s arguments, I also understand the U.S. domestic problems. What is really crucial is that there be

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no infringement by the U.S. authorities of the principles of the
Concordat. Thus, the U.S. authorities must recognize—and I think
they do—that parental responsibility operates across national fron-
tiers.

On one point, I very much agree with Alain. I too am not
sure what the U.S. authorities will do with the information they are
seeking from their reports. It certainly would be highly undesir-
able, in terms of developing and sustaining international coopera-
tion, if every country were to adopt the same procedures as the U.S.
I might comment that the objections to the Americans' original pro-
posals which have been expressed by most other major countries might
be thought to ensure that those countries would not have the pre-
sumption to impose similar procedures, as doing so would only fly in
the face of the case they are presently putting to the U.S. authori-
ties. However, before dwelling too long on an abstract debate, I
personally feel that the important thing is to see how the matter
resolves itself in practice. Often things work out better than one
might imagine and I think we should wait and see how it does work out.

B. The Principle of Consolidation

The second major element in the development of supervisory
cooperation relates to what I have described as the principle of
consolidation, touched on earlier by Alain. That is, the principle
that there should be a capacity for the parent's supervisor to un-
derstand the totality of a bank's international business, in order
to get a proper picture of that institution's overall exposure to
risk and its capital adequacy. The consolidation principle is cur-
rently being implemented to varying degrees in different countries.
The principle has been accepted by all the major countries and has
obvious implications for the way in which supervisory responsibili-
ties are carried out in practice.

3. SHARING INFORMATION

In my paper I discuss a number of other aspects of interna-
tional supervisory cooperation [1]. For the moment, I want to un-
erscore just two aspects; they both relate to information flows.
There are two basic problems. One concerns consistency of data.

This is a real headache and will continue to be so, but is an
area where everybody is going to have to work very hard to improve
consistency. Data gathered by national banking systems for their
own national purposes do not generate an adequate basis for produc-
ing data on the worldwide activities of most of the major three
hundred banks of the world. Harmonizing data procedures and data
gathering arrangements is extremely difficult. This is also very
costly to the banks and they do not like it very much. I keep tell-
ing commercial bankers that I think they should regard harmonization
of this sort as very much in their own interests. They should be
prepared to produce additional data when it is required, in order to
serve their own wider interests by having global information avail-
able. Such information will be useful in their own businesses.

The second aspect relates to bank secrecy. A great deal has
been said about this subject. Personally, I do not believe that
banking secrecy provisions in different countries are an overwhelm-
ing obstacle to cooperation among supervisory authorities. It is
mostly on the deposit side, the liability side of the balance sheet,
that the real sensitivity lies. Certainly Alain would agree that this is the case in Switzerland, which is perhaps the arch priest of banking secrecy.

It is important, of course, to know about concentration of deposits, but it is really very much more important to know about the spread of the risks on the assets side of the balance sheet. The major industrialized countries, which include most of the major banks of the world, have looked at this subject in a detailed way over the last year or two. They have concluded that while it cannot be denied that there are problems, these problems are manageable in terms of the broad objectives of international supervisory cooperation. You can get the data that you need in order to consolidate and to understand the extent of the exposure of different banks around the world. Insofar as verification procedures are concerned, if direct examination of overseas branches or subsidiaries by the parent is not feasible or permitted, it can be handled by agreements authorizing the host country supervisor to act as the agent of the parent country supervisor, or through the external audit route. I understand Neal Petersen's reservations about these routes, but in the real world, in international terms, you must accept the techniques available. I would think that most of us would feel that the external audit route for verification of data is generally a pretty acceptable one.

Now, all this cooperation I have been talking about has been in the context of the committee which meets at the BIS in Basle. We are working to develop wider cooperation across the whole world. You cannot, of course, operate a committee with a hundred or so countries, so we have just twelve. We do have gatherings where these agreements and understandings can be disseminated more widely. The federal agencies in the U.S. are organizing a conference in September 1981, in which supervisors from all around the world will meet to discuss all these problems. This conference follows one which we had in London in 1979. In the interim between these conferences, we disseminate within the supervisory fraternity the material we produce in Basle.

4. FUTURE TRENDS

To conclude very briefly, I think that the important thing to realize about international supervisory cooperation is that the international banking system is here to stay. International banking is not going to go away. There is an enormous mass of international business and no matter what changes are made in national bank regulations, the international banking system is not going to disappear, and certainly could not without a great deal of effort on the part of national authorities over a very long period of time. The growth of international banking has been accompanied by evolution of international banking supervision. I think that the basis of good cooperative work has been well established and should have significant impact on the capacity of the supervisory authority in host and parent countries to reconcile the kinds of problems which surfaced a little bit, peeked out from under the carpet, shall we say, in Neal Petersen's and Alain Hirsch's comments.

The number of countries to which this international cooperation is going to be significant is increasing all the time, because more and more banks in more and more countries are coming to have an international dimension to their business. I think the system has
enormous resilience to withstand shocks and difficulties which may occur. Good supervision all around the world is absolutely essential to maintaining that resilience.

I would like to close by echoing a remark which Bob Mundheim made at the beginning. As the system changes, supervisors have to change with it. Structurally we will see, at least in the international sphere, the closer integration of banking, investment banking, and other aspects of the international securities business. Consequently, the regulation of the banking and securities businesses may also have to be more closely integrated in order to respond not only to the internationalization of the two lines of business, but also to the increasing intertwining of the two.

I would not wish to leave you with the impression that I am over-confident about the capacity of the system to meet all the strains to which it may be subject, but I think it is very much better able to do so than it was a decade ago. I have a little notice on my desk which is a quotation from Benjamin Disraeli, an old nineteenth century prime minister in my country. It reads, "Confidence is suspicion asleep." And so I always wish to be on the guard against being over-confident about the capacity of the system to sustain strain. As my Governor put it in a recent speech, "The trouble with good health is that it is such a precarious state. It can only get worse."

5. REMAINING PROBLEMS

MR. MUNDHEIM: Fritz, did you have a comment?

MR. KUBLER: Well, there is not much I can add. Before coming here I asked our supervisory authorities in Berlin about their feelings about the present situation. I must say, everything they said confirms what Peter Cooke has told us right now. The system works very well inside Europe, and existing gaps are going to be filled. Germany is aiming at legislation for consolidation. Even at the present moment, German banks, under a sort of gentlemen's agreement with the authorities, come forward on a voluntary basis with information concerning their Luxembourg subsidiaries. So, I would like to raise only two questions.

After having listened to the dispute between Neal and Alain, my impression is that there remains a problem in Europe. The system works well when the countries involved have about the same level of supervision. But what are we going to do with the countries that are not yet at this level--and perhaps will not be for the next decade or decades? I am sure that we are in almost the same situation as the U.S. We just cannot completely prevent them from doing banking in Western Europe.

The second question to which I would like to return is the problem of secrecy. Looking at some of the more recent American legislation--for instance, at the financial privacy act you have adopted [2]--the question arises, shouldn't Europe go a little bit the same way? Of course, it cannot be overlooked that the German supervisory authority is part of the Department of Treasury. This certainly does not mean that all information they receive will go to the Internal Revenue Service. But still, wouldn't it benefit international cooperation in banking supervision if a clearly defined line could be drawn? Legislation could be enacted to specify where information may go and where it has to be withheld. I would be very

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happy to get reactions to this question from the supervisors on the panel.

MR. MUNDHEIM: Neal or Alain, do you want to respond to that?

MR. HIRSCH: The second question is the easy one, I think. We are moving toward legislation establishing the limits on the distribution of information given to a banking supervisory body, especially in the Common Market. The new Common Market text restricts the use of information given by one authority to another authority. Basically, information may be used only for supervision of banking and for nothing else. The only small problem is how to deal with a criminal offense. In some countries the notion of criminal offense is very much broader today than it was in the past. It can mean even a very, very minor offense. So, there are still some problems, but I think on the whole, we are in the clear.

Your first question is the more difficult one. What if a bank coming from a country where the supervisory organization is still weak wants to do business in Europe? I think we should then say, "If you are not internationally supervised in the proper way, then we will look with a very, very close eye to see if you may have, for instance, an independent subsidiary in Switzerland or in Germany." An economically independent subsidiary should not be part of an international group or community which is not properly supervised. In practice, that would mean applying some version of your Form Y-8f but probably even tougher. It seems to me that there is no alternative to this, even if it is difficult to implement it.

MR. COOKE: May I add a comment on those two points? On the question of the countries with less supervision, this is, of course, a vexatious problem. It raises the problem which Neal referred to of discrimination between one kind of national supervisory system and another. This may be, on occasion, very difficult to do.

In our Banking Act of 1979, which is the basis for our present supervisory arrangements, there is a specific provision which requires us to have regard for and be in contact with the supervisory authority of the parent entity of any foreign banking institution which wishes to set up a branch or a subsidiary in the United Kingdom. It is within our powers either to accept or not to accept the adequacy of that supervision as fulfilling a number of the requirements that we otherwise would have to address ourselves. If we do not accept it, then we have the difficult problem which Neal referred to of having to appear to be discriminating against that country by saying that we do not think much of its supervision and, therefore, have to do the job ourselves. That is a difficulty, but at least the problem is recognized in our legislation and we have a handle to grasp in that regard.

On the general subject of the development of international banks around the world from less supervised or unsupervised centers, I think I should say that the major countries are all very clearly agreed on what is the desirable principle here, that you should not allow an entity from an unsupervised center to develop an international business. That is easier said than done. There are countries that have in the last year or two passed legislation authorizing the creation of new banks within territories that are specifically excluded from that country's supervisory regime. Banks that take advantage of this legislation may be consortium banks with entirely respectable parentage, interested in pursuing international business
from a tax and supervisory haven within a country. But in principle, we are very unhappy about the proliferation of such entities around the world and do our best to stop them from operating worldwide from an unsupervised base. I am sympathetic on the whole to the view that banks should not be allowed to enter a country if the host country bank supervisory authority has forbidden it and where it believes there is no supervision or the quality of supervision of the parent is unsatisfactory.

On secrecy, the second point, I think the particular sensitivities relate to deposits. The other sensitivities of most European countries relate to hidden reserves. This is a subject that is going to be debated fairly hotly in Europe over the next year or two because, as Alain indicated, there is a bank-accounts directive now before the European Community which seeks to settle the basis on which hidden reserves can be maintained. This problem will likely be with us for a long time.

The important point about secrecy is that it should not preclude supervisory authorities from communicating information which is in their possession to other supervisory authorities when this is in the interest of international banking supervision, that is, when it is in the interest of banks generally operating in the countries of the different supervisory authorities among whom this information is being exchanged. I would very much hope that that principle of free exchange of information for this purpose can be enshrined in national laws as it is enshrined in the new United Kingdom legislation [3].

MR. MUNDHEIM: I promised to let Fred Heldring ask a question.

MR. HELDRING: Peter, I was one of those who read your text in hushed silence up in my room this morning. One of the sentences in your report raises a question in my mind. The aim of the Concordat is to sustain, as far as possible, by effective supervision the health and safety of the existing structure; and I am very impressed with all the progress that has been made in that respect. Then you go on to say that the Concordat does not set out to rule on the way in which the pieces of the structure should be picked up if it is broken.

May I ask your opinion about whatever infrastructure is being built upon a similar basis of international cooperation to take care of a breakdown in the structure at one place or another? Do you think there is as much progress in that area as in supervision?

MR. COOKE: You are opening up a very big question which perhaps goes a little bit beyond the scope of today's discussion, although it is obviously very closely related to the ongoing supervisory process. I think that the lender-of-last-resort function in terms of international business is an immensely complex one. I, for one, believe it is important that it should not be made too specific. There is a principle of moral hazard which we should observe in the international banking system. The Governors of the major central banks of the world issued a communiqué on September 10, 1974, at the most troubled time in international markets, in which they said rather delphically that means were available to deal with any problems that might arise, and I think we should leave it at that.

MR. MUNDHEIM: Alec, you wished to make a brief comment?
MR. VAGLIANO: Very brief. As an American bank we are, of course, accustomed to a large amount of disclosure; and when it does not affect customers' confidentiality, we are quite inured to that. However, one point that came up today is the possibility that the regulatory authorities in the many jurisdictions in which we do business may move to global supervision, that is supervision of our overall global activities. I would be very concerned that this could eventually lead to inconsistencies and even conflicts where we would be right in the middle. So I would, in that context, support cooperation between the supervisory authorities.

NOTES

[1] See 58 to 63 infra.


APPENDIX IV

DEVELOPMENTS IN CO-OPERATION AMONG BANKING SUPERVISORY AUTHORITIES

W. Peter Cooke

INTRODUCTION

International co-operation among banking supervisory authorities is a relatively new phenomenon. It emerged in the 1970's alongside the burgeoning international banking activity which had developed significantly in the 1960's and has continued to grow apace thereafter. I will review the growth in co-operation which has taken place during recent years from the particular perspective of the Basle Committee on Banking Regulations and Supervisory Practices which has provided a focal point for that co-operation.

THE NEED FOR INTERNATIONAL SUPERVISORY CO-OPERATION

The internationalization of banking brought about considerable changes in banking systems and in the conduct of banking business. New international markets grew up with their own techniques and conventions and new kinds of risks. The number of international financial institutions grew considerably as banks expanded across national frontiers through the establishment of subsidiaries and branches in many countries to service the needs of their customers--large and small--on an increasingly international basis and to take advantage of the newly created markets. New types of bank were formed, particularly the so-called consortium banks with shareholders from many different countries. New financial centres developed--notably those which are broadly categorized as "offshore" centres--where banks were attracted by favourable fiscal and regulatory environments to conduct a significant part of their international operations. The proliferation of new banks operating across national borders sometimes led to a situation in which foreign branches and subsidiaries of banks in one country operating in the markets of another country fell outside the perceived responsibilities of the supervisory authorities in either country. More generally, the high degree of cross border interbank borrowing and lending through the ever-growing activity of the Euro-markets meant that banks became increasingly dependent for much of their liquidity on banks in other countries and on currencies other than those of their country of origin.

Looking back, it is now clear that at the beginning of the 1970's the perceptions and techniques of banking supervisory authorities around the world had not kept pace with these developments. There was in effect a supervisory vacuum in this new global market which needed to be filled. Neither the supervisors, nor indeed the banks themselves, had fully appreciated the degree to which the banking environment was changing in character and the new increased risks involved in international business. Supervisors were still very much domestically oriented within the framework of different national banking systems. Indeed it is difficult now to realize how little contact there was at that time between those responsible for banking supervision in major countries.

MOVES TO DEVELOP INTERNATIONAL SUPERVISORY CO-OPERATION

The banking environment to which supervisors needed to respond was thus changing radically--particularly in those countries where the world's major banks were situated. The events of 1973 and 1974, when a number of banks in different countries failed (notably the Herstatt Bank in 1974) and others experienced serious losses, highlighted this changed environment and precipitated more urgent action.

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In response to these events, the Governors of the world's major central banks took action to allay the concerns about the viability of the international financial system. They issued a statement in September 1974 to the effect that, while it was not practical to lay down in advance detailed rules and procedures for the provision of temporary support to banks experiencing liquidity difficulties, the means were available for that purpose and would be used if and when necessary. At the same time the Governors concluded that a better co-ordination of the surveillance exercised by national authorities over the international banking system was necessary and to that end they created a new standing committee—the Committee on Banking Regulations and Supervisory Practices with members drawn from the Group-10 major industrialized countries and Switzerland.*

The first formative steps to bring together supervisors in major banking countries had in fact been taken two years earlier in 1972 when, at the time of the impending UK membership of the European Community, an informal and autonomous group of those with operational responsibilities for banking supervision in EEC countries was set up. Known as the Groupe de Contact its principal aim was, and is, to achieve closer understanding and practical co-operation between the banking supervisory authorities of the Member States. In recent years the Group has also taken on a technical role for the Advisory Committee for Banking Co-ordination (set up under the First Banking Directive of the European Community to advise the European Commission on moves to harmonize the banking systems of the Community and their regulation).

The Basle Committee of Supervisors met for the first time in February 1975. Its first Chairman was Mr. George Blunden of the Bank of England; and I succeeded him in 1977. The Committee has met regularly over the past six years—normally three times a year.

There were two major tasks confronting banking supervisors which became apparent to the Committee. The first was the need to adapt the national supervisory system within each country in order to cope with the wider dimensions of their major banks' businesses. The second and complementary task was the promotion of close co-operation between national authorities in monitoring the activities of the overseas branches, subsidiaries and affiliates of their own banks and the offshoots of foreign banks in their own territories. The Committee has provided a forum over the years in which supervisors can learn of each other's techniques and experience and hear of problems that may be emerging in different national systems and could be of wider concern. It has been particularly valuable in establishing close personal contacts between supervisors in different countries—relationships which in a number of cases have facilitated rapid and effective co-operation between the authorities concerned when banks operating within their respective jurisdictions have experienced problems. More generally, the Committee has worked to develop broad principles with which different national supervisory authorities can be encouraged to conform in settling their own detailed arrangements. It is not, however, a forum which specifically sets out to harmonize banking supervisory arrangements. National systems have grown up with different traditions: some with detailed statutory arrangements, others with more informal and flexible supervisory frameworks; some have comprehensive examination procedures, others do not. In practice, however, members of the Committee have found much to learn from each other and this mutual learning process may well over time produce some convergence between national systems which can only be beneficial. In all member countries the past few years have been a period of considerable activity in the field of banking law and regulation. Most have enacted or are

* Committee members come from Belgium (and Luxembourg), Canada, France, Germany, Italy, Japan, the Netherlands, Sweden, Switzerland, the United Kingdom and the United States.
preparing major legislation and in every case this legislation reflects, albeit to varying degrees, accords which have been reached in Basle or the incorporation in the national laws of one country desirable features of the arrangements prevailing in others.

THE DEVELOPMENT OF THE BASLE COMMITTEE'S WORK

In the first period of the Basle Committee's work it concentrated on carving out first principles for international supervisory co-operation. They had to be built up from virtually nothing. The first priority was to reach an understanding of the appropriate division of responsibility between national authorities for the supervision of banks' foreign establishments with the object of ensuring that no foreign banking establishment escaped supervision. The general statement of the Committee's views on this subject which was subsequently endorsed by the Governors in December 1975, has become known as the Concordat. I will discuss this in more detail later. The importance of this early agreement cannot be emphasized too much. It represented the first, and a most significant, co-operative step forward, and even if it may have been a step made easier by the pressure of events at the time, it was nonetheless a considerable achievement which laid the foundation for later co-operative efforts. Another matter to which the Committee turned its attention at the outset was how an early warning system of potential problems in national banking systems might be organized. It was concluded that such problems could not in practice be handled through a separate monitoring system operated by an international body. Because of differences in national systems and legislation co-ordination would be difficult and would anyway tend to duplicate national arrangements. Action to counter potentially dangerous situations should thus be taken by the national supervisory authority most concerned in consultation with other countries as appropriate.

As the disturbances to the system lessened and immediate concerns were allayed the Committee settled down to examine the supervisory tools and arrangements that would be necessary to facilitate implementation of the basic guidelines enshrined in the Concordat and to develop co-operation further. A major recommendation was the use of supervision on a consolidated basis whereby the capital adequacy and risk exposure of international banks would be monitored on the basis of their worldwide business. The Committee also began to look beyond the specific type of risk which had underlain the Herstatt crisis (foreign exchange risk) to a detailed examination of other types of risk facing international banks—especially the degree of maturity transformation effected by individual banks and the system as a whole—and the problems of measuring and monitoring country risk.

As the Committee's work progressed substantial efforts were made to involve in the discussion process supervisors from a wider group of countries than those represented on the Committee since it was realized that to be effective, the supervision of international banking activity should be as comprehensive as possible. From the outset a number of the Committee's papers had been circulated widely within the supervisory community for information and for comment, and in 1979 it was decided to provide a forum for this wider group of supervisors to meet and discuss the Committee's work and its conclusions to date. Accordingly, an International Conference of Banking Supervisors was organized by the Bank of England in London in July 1979. It was attended by bank supervisors from about 80 countries, representing Europe (Eastern and Western), North, Central and South America, Africa, the Middle East, the Indian subcontinent and the Pacific basin. A variety of topics was discussed covering many of the principal areas of the Committee's work up to that time, including the division of supervisory responsibility; co-operation between bank supervisors; capital and liquidity adequacy; foreign exchange controls; consolidation; and the role of the offshore centres. This was the first occasion ever on which supervisors worldwide had had an opportunity to meet together, to establish personal contacts, and to exchange views on international aspects of banking supervision.
The supervisory agencies in the U.S. have already announced that they will be organizing a similar conference to be held in Washington in September 1981 and we hope meetings of this kind may become a regular feature of the international banking scene so that the work of the Committee of Supervisors meeting in Basle may continue to be disseminated to the widest possible audience and the Committee itself may profit from the ideas of those who do not take part in its regular deliberations. Mention has already been made of the work of the Groupe de Contact (some of whose members also sit on the Basle Committee). The studies of this Group have frequently made a valuable contribution to the development of subjects considered in the wider forum of the Basle Committee; for example, the concept of consolidating banks' international business to make international supervision more effective was first discussed in the Group. Other regional and more specialist groupings of supervisors have also met from time to time and are being encouraged. One example of these was a joint meeting of supervisors from the Group-10 countries and the principal offshore centres which was held in Basle in October 1980. During this meeting a number of subjects were discussed, including exchanges of information, consolidation and supervisory standards, and procedures for consolidation and supervision—on all of which a community of approach and considerable measure of agreement was achieved.

AREAS OF CO-OPERATIVE ACTION

I want to turn now to a somewhat more detailed description of the principal areas of work to date in the Basle Committee.

A. The Division of Supervisory Responsibility: The Concordat

It is appropriate to begin with an outline of what has come to be known as the Concordat on International Supervisory Co-operation. It sets out guidelines covering the responsibilities of different supervisory authorities for the ongoing supervision of banks where those banks operate in more than one national jurisdiction. It is not, and was never intended to be, an agreement about responsibilities for the provision of lender-of-last-resort facilities to the international banking system; and there should not necessarily be considered to be any automatic link between acceptance of responsibility for ongoing supervision and the assumption of a lender-of-last-resort role. The aim of the Concordat is to sustain as far as possible by effective supervision the health and safety of the existing structure. It does not set out to rule on the way in which the pieces of that structure should be picked up if it is broken. The Concordat encompasses the following guidelines and recommendations:

(1) The supervision of foreign banking establishments should be the joint responsibility of host and parent authorities.

(2) No foreign banking establishment should escape supervision, each country should ensure that foreign banking establishments are supervised, and supervision should be adequate as judged by both host and parent authorities.

(3) The supervision of liquidity should be the primary responsibility of host authorities since foreign establishments generally have to conform to local practices for their liquidity management and must comply with local regulations.

(4) The supervision of solvency of foreign branches should be essentially a matter for the parent authority. In the case of subsidiaries, while primary responsibility lies with the host authority, parent authorities should take account of the exposure of their domestic banks' foreign subsidiaries and joint ventures because of the parent banks' moral commitment in this regard.

(5) Practical co-operation would be facilitated by transfers of information between host and parent authorities and by the granting of permission for inspections by or on behalf of parent authorities on the territory of the host authority. Every effort should be made to remove any legal restraints (particularly in the field of professional secrecy or national sovereignty) which might hinder these forms of co-operation.
To make the Concordat fully effective internationally its principles will have to be endorsed by supervisors worldwide. The London Conference in 1979 examined the terms of the Concordat and, although no formal decisions were taken, there was general acceptance of its principles by those participating. The supervisors from the major offshore centres meeting in Basle in October 1980 also felt able to endorse its principles. It should be stressed, though, that the Concordat's guidelines are not fully implemented in practice and certainly not in law, and there remain areas where the division of responsibility is not entirely clear and where banking secrecy provisions are to a degree an impediment to its effectiveness.

Despite elements of imprecision—in inevitable in agreements on principles when responsibilities are shared—the Concordat nevertheless has become established as a most important cornerstone of international supervisory cooperation. Its operation has recently been reviewed by the Committee who have concluded that it is still soundly based and a valuable aid to international supervision.

B. Consolidation

The second major plank, developed over the past three years, of the Basle Committee's approach to international banking supervision is the principle that banks' international business should be monitored on a consolidated basis.

The Committee made its first recommendation to the Governors on the merits of supervision on a consolidated basis in 1978. The practice of consolidating the totality of a bank's international business permits its capital adequacy and risk exposure to be assessed on the basis of its worldwide business, including that of its foreign branches, subsidiaries, and affiliates. This prevents banks from "gearing up" imprudently on their capital or increasing their risk taking beyond acceptable bounds through the establishment of operational presences in foreign countries where the solvency and other prudential requirements might be less tight than in the parent country. Consolidation in effect provides a clearer picture of a bank's overall exposure to risk and enables parent supervisors to apply their own standards to the monitoring of their banks' business irrespective of where that business is conducted. Consequently it is an invaluable aid to parent supervisors in enabling them to fulfill in practice their responsibilities under the Concordat for the supervision of the solvency of their banks' foreign affiliates.

The Governors have strongly endorsed the consolidation principle and recommended its early implementation. Since 1978, good progress has been made in a number of countries to push ahead with the introduction or extension of supervision on a consolidated basis for their banks' international business, and others have plans to do so. Banks in Canada, the Netherlands, and the U.S., for example, have for several years been required to consolidate their foreign branches as well as significant wholly-owned subsidiaries for supervisory purposes. Japanese banks have been required to consolidate the accounts of their foreign branches for several years and those of significant wholly-owned and majority-owned subsidiaries since 1978. In the United Kingdom new reporting arrangements were introduced during the course of 1979 to cover the international risk exposure of all UK incorporated banks on a fully consolidated basis which should be fully effective by the end of 1981. In December 1980 the Swiss authorities adopted the necessary provisions to formalize the use of consolidated accounts for the purpose of assessing capital adequacy. In Germany the Gessler Commission's study of the German banking system published in May 1979 recommended the consolidated approach to supervision as a means of dealing with the problem of German banks abroad creating so-called "credit pyramids", and legislation is currently in preparation. Further impetus to the adoption of the principle of consolidation in other EEC countries may come in the relatively near future from proposals for a Community directive, recommended by the Advisory Committee at the end of last year, which would make worldwide consolidation for supervisory purposes obligatory for EEC countries.

A recent review conducted by the Committee concluded that good progress was being
made in applying the principle of consolidation but that much still remained to be done especially in improving the availability and consistency of statistics.

C. Solvency and Liquidity

Effective monitoring of banks' solvency and liquidity adequacy lies at the heart of the national supervisory systems. Over recent years supervisors have been concerned at the weakening of capital, or solvency, ratios that has occurred in a number of countries, due in varying degrees to the rapid expansion of international business, a high degree of competition, the erosion of margins, and inflation constraining real profitability. This tendency has been accompanied and reinforced by many banks' reluctance or inability to attract new equity capital and their increasing use of subordinated debt as a substitute—a development accepted rather reluctantly by supervisors.

In an international setting, the need to sustain an adequate solvency profile for banks can be met through the application of the principle of consolidation to a bank's worldwide business without fundamental changes in approach from that pursued at the national level. Up to now the Basle Committee in considering solvency questions has concentrated particularly on attacking the problem through improved consolidation arrangements.

Handling liquidity adequacy questions is more complicated because many currencies are involved and there is no formalized lender-of-last-resort responsibility vested in any one body in international markets as there tends to be for the domestic currency in a national market. The Committee has shared the concern which has been voiced by some that the rapid increase in international lending in the 1970's has been accompanied by a lengthening of maturities and an increased mismatch between banks' assets and liabilities. This gives rise to an interest rate risk and a funding risk, and while in theory the rollover technique should alleviate the first of those risks, banks may not match exactly to rollover dates. In practice also some banks may not be able to re-fund their lending at acceptable rates, particularly when interest rates are rising steeply.

Although there are differences of emphasis among its members, the Committee considers that the degree of maturity transformation effected by banks in their international business is a matter of especial importance to supervisors because funding problems are not infrequently the origin of a problem bank situation. More important, there is the risk that the increased interdependence of banks for their liquidity management could lead to domino effects throughout the international banking system in the event of problems emerging in one corner of it.

Faced with an inadequacy of statistics in trying to assess the extent of and variations in the mismatching being effected by banks in the conduct of their international business, and in order to be able to make valid international comparisons, the Committee, at the request of the Group-10 Governors, began in 1978 to examine the construction of a uniform reporting system for the collection of data on banks' maturity transformation in their international business. Following extensive discussions, and with the Governors' support, it was agreed in September 1980 that a twice-yearly reporting system should be put in train under the aegis of the BIS with the object of producing aggregated consolidated data on a consistent basis, with fairly detailed maturity breakdowns from sight to 7 years, covering all the international assets and liabilities of reporting banks. With a completely new system. But despite such additional reporting burdens for the banks, which for many countries, including the U.S., come on top of recent major revisions to reporting requirements, it seemed to the Committee that it was a matter of considerable priority that better data on this very important aspect of international banking activity should be made available and that these requests for information
being made to the world's major banks were fully justified. In view of the relatively untried and untested nature of market conventions with respect to liquidity management and further recycling pressures which could well arise in the future, supervisors need to be in a position to improve their capacity to assess the maturity patterns and potential liquidity problems of their banks in the international banking system as a whole.

D. Country Risk

Much has been written about international banks' exposure to country risk. A difficult concept to define with precision, country risk refers to the possibility that borrowers of a particular country may be unable or unwilling to fulfill their foreign obligations because of actions taken by that country's government to conserve foreign exchange reserves or for some other reason. This category of risk, which embraces both sovereign risk lending and lending to commercial entities in foreign countries, has become of increasing concern to banks and supervisory authorities because of the rapid expansion of international lending, particularly to developing countries as part of the recycling process, to a degree which at a time of adverse economic conditions worldwide could call into question the ability of some borrowers to repay their loans as they fall due. The Basle Committee has kept this subject under review over recent years. The basic attitude of supervisors generally can be simply expressed: country risk, as one form of credit risk, is a matter for the commercial judgment and decision of each bank on a case-by-case basis. But as with all kinds of risk exposure in banks' business the essential characteristic is that it should not be excessive in relation to a bank's capacity to meet losses. The supervisors' particular concerns should be: (1) to assist banks to assess the risks they are running by ensuring that the best possible data bearing on the lending decisions is available; (2) to ensure that the banks have adequate internal assessment and control procedures; and (3) to improve prudential reporting and monitoring systems.

A number of steps have been taken over the last few years in line with this approach. Following the Herstatt affair it became clear that an improved statistical breakdown of banks' exposure by country was needed. In 1977 the BIS began to produce twice-yearly data on the maturity structure of the claims of banks in the Group-10 area and certain other centres and in 1979 issued a comprehensive manual on country indebtedness designed to direct the banks to statistical source material for assessing country risk. Many countries' measurement and control systems of this kind of exposure have been improved. For example, in 1978 the main supervisory agencies in the U.S., which have done much pioneering work on methods of country risk analysis, agreed on a common approach to the isolation of country risk, including a checklist of factors to evaluate the banks' ability to monitor and control their country risk. More recently the German and Belgian authorities have asked auditors to include in their annual reports on banks an evaluation of the banks' methods of country risk measurement and control. The U.S. and the United Kingdom are now collecting country exposure information on a consolidated basis. Other countries too are considering similar moves.

E. Other Work

In addition to the work in these major subject areas the Committee has examined a wide range of other issues of concern to supervisors of international banking business. Each meeting gives members an opportunity to keep up-to-date with recent developments in each other's rules and practices and to hear of problem situations and how they have been handled. Subjects that have been studied, or on which recommendations have been made to the Governors, include broad comparisons of the supervisory systems in operation in each country and of various aspects of the banks' own internal procedures to control foreign exchange operations, relations with brokers, official regulations, and the role of supervisors. The Committee has also reviewed the various attitudes adopted by member countries with regard to the role of loan capital in a bank's balance sheet, requirements
for endowment capital for foreign branches, arrangements for bank audits, and affiliation relationships between banks and non-banks. Other areas of study have included the role of profit and loss analysis in bank supervision; techniques of rescue and support; deposit protection arrangements in different countries; the supervision of banks' trust business; and the prudential implications of certain aspects of loan syndication agreements. In addition, the Committee has been involved with the accounting profession internationally and the International Chamber of Commerce on technical work relevant to international banking business.

F. Information Flows

The free flow of information across national borders between banks and supervisors is a crucial feature of effective international co-operation between supervisory authorities.

Bank secrecy laws or regulations in some countries can enjoin banks not to reveal information about their customers and can preclude supervisors from divulging to other supervisory authorities information that they have acquired in the course of their duties. Obstacles to free cross-border flows of information between foreign offshoots and their parents and between host and parent authorities, while their significance should not be overemphasized, raise a number of practical barriers to fully effective co-operation. First, foreign establishments may not be able to reveal information to their parent banks or the parent bank may invoke the secrecy rules of the host country not to divulge information to its parent authority. Second, host authorities may be precluded by local laws or practice on professional secrecy from revealing information about the banks under their supervision to parent authorities. Third, differences in the laws of professional secrecy applied to different supervisory authorities could potentially make information less well protected in one country than in another. Finally, parent authorities may be prevented from conducting on-the-spot inspections to verify the information they receive.

Since such impediments can clearly impair parental supervision under the Concordat, consolidated supervision, and co-operation in general, the Basle Committee is working to reduce these obstacles but believes that, at least amongst its members, secrecy provisions do not in practice operate substantially to impair supervisory co-operation. In particular, use of banks' external auditors may help alleviate some of these impediments. An important step forward in removing the legal barriers to exchanges of information between supervisors was made in the First EEC Banking Directive, adopted at the end of 1979, which requires Member States to permit the exchange of information between supervisory authorities about the management and ownership of credit institutions and data necessary for monitoring their liquidity and solvency. More recently, there have been signs of a greater willingness on the part of other countries to relax secrecy rules for purposes of international supervisory co-operation. These are encouraging developments in what must be recognized to be a gradual process, since bank secrecy constraints are deeply rooted legal or customary attitudes in many countries around the world and will not be quickly or easily removed.

Another area of concern in ensuring that effective exchanges of information can take place is the consistency of the data. Differences of style and techniques and of intensity of supervision lead to considerable variations in the amount and form of the information required by national supervisory authorities. Much of the information supplied by the banks is designed to meet not only prudential but also monetary and statistical purposes for which information needs differ widely between countries. What is more, during the last few years, as a result of the rapid change in banking and supervisory arrangements in the 1970s, many countries gave considerably amended and generally enhanced their national reporting systems. This has placed burdens on banks and the authorities have to strike a sensible balance between securing important informational objectives and making excessive demands on their banks.
A start has been made on "international" reporting with the collection of reasonably consistent data on country exposure and maturity transformation. As these reporting systems are improved and consolidation reveals what further coordination is necessary on a broader front, it may be hoped that models will evolve on which future changes in national systems can be based. In the meantime, at this experimental stage in the collection of "international" data, the banks—and supervisors—will have to recognize that some duplication of existing systems and allocation of extra resources are inevitable but that these should be borne with for the general good. Over time the Committee will be working to achieve a greater degree of agreement about the purposes which data should serve so that all countries will have a better basis for considering sympathetically the desirability of standardizing systems for the production of such data.

CONCLUSION

The initial moves toward international co-operation in banking supervision in the mid-1970s arose out of problems associated with the rapid growth of the Euro-markets and the strains of international recycling following the first major oil price rise. As the 1980s began, in the light of the continued growth in international business and pressures from further oil price rises, the Central Bank Governors of the Group-10 countries and Switzerland took a further close look at international financial markets and banking activity. They concluded that high priority should be given to the maintenance of the soundness and stability of the international banking system.

To enhance the authorities' surveillance capacity the Standing Committee on Euro-markets was charged with the regular review of international banking statistics and other relevant information. Thus developments in the macro-economic field, which profoundly affect the environment within which supervisors operate in working to sustain the soundness of individual banks, are now being regularly monitored. At the same time, in their communique of April 1980, the Governors referring to the risks run by individual banks reaffirmed "the cardinal importance which they attach to the maintenance of sound banking standards—particularly with regard to capital adequacy, liquidity and concentration of risks. To this end they place high priority on bringing into full effect the initiatives already begun by the Committee on Banking Regulations and Supervisory Practices with regard to the supervision of banks' international business on a consolidated basis, improved assessment of country risk exposure, and the development of more comprehensive and consistent data for monitoring the extent of banks' maturity transformation." Thus, some at least of the tasks of the international supervisory community in the early 1980s have been signposted.

The last few years have seen the emergence of a strong sense of community of interest among those responsible for supervising the international business of banks in full awareness that the health and safety of individual banks now depend on the soundness of the whole international banking system. The knowledge that this co-operation exists provides reassurance to the markets that the international banking system is being effectively supervised and that, should problems emerge, contacts and understandings exist and experience can be shared to ensure that speedy solutions can be found to minimize the extent of any disturbance to the system.

The Basle Committee, and the Contact Group, have played a pivotal role in this process. They have provided a forum for mutual education about each other's systems; for the exchange of confidential information within the bounds of each country's secrecy rules; for the study of individual problems to learn the lessons they contain for supervisors; for the elaboration of guidelines that should govern the supervision of banks' international business; and perhaps most important of all, for the establishment of personal contacts which has led to practical continuing collaboration outside the confines of the committees in an atmosphere of mutual confidence and trust both in routine matters and in individual problem cases.
The result of these contacts and exchanges has been to create a new international approach to banking supervision. The foundations of international cooperation in supervisory responsibilities have been laid, notably in the Concordat and the recommendations on consolidation. In addition, new international guidelines, frequently incorporating the best of individual countries' experience and developed through international discussion, often in a spirit of real compromise, are coming to be widely accepted by authorities worldwide and are increasingly being reflected in the legislative and administrative measures undertaken by individual countries.

Moreover, in framing new policies many countries increasingly seek possible models in the methods of other countries, and this is creating a slow but perceptible trend towards convergence of supervisory techniques based on best practice. More remains to be done in the 1980s but a basic international framework for future co-ordination and co-operation, both among the major industrialized countries and more widely, has already been established.